

When to Sell a Winner

There's no tougher question you can ask a value investor than "When do you sell?" Buying cheap stocks is (relatively) easy. Knowing when to sell them after they're no longer screaming bargains is hard. The good news, however, is that you really rarely need to sell at all.

By Rich Smith
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Investors, it seems, are getting antsy. They're starting to catch on to the fact that true bargains in stocks are very hard to come by -- a fact highlighted in Warren Buffet's recent [letter to shareholders](#) of Berkshire Hathaway ([NYSE: BRKa](#)). If the reigning king of successful investors can't find a bargain out there, Fool readers are asking, does this mean it's time to sell?

To which I reply with a question of my own: "Um, time to sell what?"

Could you be more specific?

Both are important questions, of course. But my question is better. Because when investors ask "is it time to sell?" they're making the unspoken assumption that all stocks are created equal -- that if "The Market" is overpriced, then it doesn't really matter whether you own XTO Energy ([NYSE: XTO](#)), Home Depot ([NYSE: HD](#)), or Lucent ([NYSE: LU](#)). If the market's overpriced, you oughtta sell 'em all.

Nonsense. It's entirely possible for the market as a whole to be overvalued, yet include stocks that are grossly overvalued, stocks that are fairly priced -- and, yes, stocks that are undervalued, too. To illustrate, let's take a look at one of the most widely used methods for determining fair value: the PEG ratio. A PEG is a company's price-to-earnings ratio (P/E) divided by its growth rate (G). When a company's PEG equals 1.0, it's probably close to fairly valued. The higher the PEG, the pricier; the lower the PEG, the cheaper.

Currently, the S&P 500, which we can use as a proxy for the market at large, has a PEG of 1.5. So Buffet is right in arguing that the market is expensive. (Big surprise. The guy *is* a genius, after all.) But among companies that make up the S&P 500, valuations vary widely. For example, at a PEG of 2.7, Lucent is nearly twice as "overvalued" as the average American company; Home Depot, at a PEG of 1.1, is pretty close to fairly valued; and XTO? At a PEG of 0.8, that one actually looks to be a bargain. Fancy that -- an underpriced stock in an overpriced market. Who'd have thought?

Us, that's who

As small-cap value investors, our team here at [Hidden Gems](#) knows that there's value to be found in even the most overpriced of markets. We actively seek out the best values in small companies and, to date, our members have been well rewarded for the effort: We're trouncing the S&P's return by a margin of nearly [4 to 1](#).

Perversely, that's created a bit of a dilemma for many of our members. They've seen their stakes in companies like **FARO Technologies** and **Transkaryotic Therapies**, **Middleby** and **Saucony**, all more than double in value over the course of a few months. And some are beginning to wonder whether it's time to take some winnings off the table. To perhaps invest that money in a few of our other recommendations. Or to just stash it away until the market in general becomes cheaper.

Easy question first

First things first. No, I do not believe you should sell stocks that have performed well and put that money in a mason jar buried in the backyard or in a savings account -- a near equivalent at today's interest rates -- "hoping" the market turns south so that you can buy back into it.

Do you remember when it was that Fed Chairman Alan Greenspan first decried "irrational exuberance?" 1996. Greenspan was right, sure. But the market proceeded to climb for another four years before heading south. If Alan Greenspan, a man whose body is approximately 92% brain, can't time the market accurately, there's scant chance that you or I can. Don't even try.

Now it gets harder

But let's say you've bought into a cheap stock, seen it rise impressively over the past few months, and now want to buy something that hasn't yet made its own climb to the heights. That's a dilemma I personally face right now with **Nokia** ([NYSE: NOK](#)), a stock that I bought "on sale" several months ago, and that's now up more than 50%. I don't intend to sell it any time soon, and here's why.

The market ain't your momma

The market doesn't know you. It doesn't know how much you paid for a stock. It doesn't care how much you've made or lost. The market just tries to value companies based on their intrinsic worth and future prospects. Your objective as an investor should be to emulate the market's dispassion, to avoid getting emotionally attached to your stocks.

What I mean is this: Whenever you are tempted to sell a stock, you should, to the best of your ability, attempt to forget how much you paid to buy it originally. If you bought **Google** ([Nasdaq: GOOG](#)) six months ago at \$100, and it's now selling for nearly twice that, this does not necessarily mean you should sell quickly, before the stock collapses. The law of gravity doesn't apply to the stock market. Not all things that go up must come down.

Neither does gravity affect stocks in reverse. If you bought **Ciena** ([Nasdaq: CIEN](#)) last year at \$5, and today it's selling for \$2, your decision to hold onto the stock, to sell it, or to buy more, should have *absolutely nothing* to do with whether you think you will "get back to breakeven." This is important enough that I want to repeat it: The market *does not care* how much you paid for Ciena. There is no guarantee that, just because it once sold for \$5, it will ever fetch that much again.

Valuation is everything

The right time to sell a winner is, as investing guru Philip Fisher famously wrote: "almost

never." If you've done your research beforehand and determined that the stock you want to buy is a promising long-term investment, you should not want to sell it -- ever. Trust your instincts. And, more importantly, trust the research and effort you put into buying a stock in the first place. Don't throw that away for a couple of percentage points gain.

That said, when you're looking at not just a couple of percentage points, but a double- or triple-digit gain over the course of a few short months -- as many of our members are -- I understand that the temptation to lock in that gain can be immense. But don't succumb. Remember that a business resembles an individual, in that it's dynamic and always changing. But as Fisher pointed out, "...there is no limitation to corporate growth such as the life span places upon the individual." A business can easily be undervalued today -- and *still* undervalued next year, despite a rise in its stock price.

Consider: Company A earns \$1 during Year 1, has a price of \$10 and a resulting P/E of 10. Now assume that in Year 2, Company A earns \$1.50. Meanwhile, its price has increased to \$14. That's a 40% gain in price -- enough to make most investors want to take a bit of money off the table.

But hold on a sec. The company's P/E has actually *fallen* to 9.3 over the past year (and I won't even talk about its PEG.) Company A is therefore a better deal at the end of Year 2 than it was at the end of Year 1. This would be a perfect example of the kind of company you'd be foolish (small "f") to sell in order to capture some profits.

It's also a good example of what I'd suggest you do anytime you're tempted to sell a winner. You know why you bought the company in the first place. You know what calculations you used to determine that it was worth buying. So before selling, *do it again*. Run the numbers. Give the stock another chance to prove to you that it's worth owning. If the company fails the test, if you simply cannot convince yourself, no matter how hard you try, that the company is still worth owning, then fine -- sell it. But if the company proves itself to you, don't cut your profits off at the knees. Hold on to that little winner. Let it live. Let it grow. Let it continue to generate profits for you and your descendants for as long as you all may live.

Does the stress of knowing when to sell a winner keep you up at night? Or are you having trouble finding winners at all? For a very modest fee, Motley Fool Hidden Gems editor Tom Gardner will do the worrying -- and the research -- for you. Is he any good? I wouldn't be inundated with email from readers wanting to know whether they should sell their winners if Tom hadn't found those winners for them in the first place! But don't take my word for it. Sign up for a [free trial](#), and take a full month to decide whether [Hidden Gems](#) is right for you.

Fool contributor [Rich Smith](#) owns shares of Nokia, but of no other company mentioned in this article. The Motley Fool's [disclosure policy](#) is always a "buy," never a "sell."